RW1-2-04

J. C. Cox Utilities, Inc.

Application for approval of new schedule of rates and charges for sewerage service provided to its customers in Anderson County, South Carolina

Docket No. 2003-277-S

Direct Testimony
Steve W. Gunter
Audit Department

Public Service Commission of South Carolina

RETURN DATE: OK Dw
SERVICE: OK Dw

TESTIMONY OF STEVE W. GUNTER

FOR

PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA

DOCKET NO. 2003-277-W

IN RE: J.C. Cox Utilities, Inc.

Q. **PLEASE STATE FOR THE RECORD YOUR NAME, BUSINESS ADDRESS AND POSITION WITH THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA.**

A. My name is Steve W. Gunter. My business address is 101 Executive Center Drive, Columbia, South Carolina. I am employed by the Public Service Commission of South Carolina as an Auditor.

Q. **PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND YOUR EXPERIENCE.**

A. I received a B.A. Degree in Interdisciplinary Studies with a major in Accounting from the University of South Carolina in 1980. I am a Certified Public Accountant, certified in the State of South Carolina. I have 21 years of experience in the auditing profession. Twenty of those years have involved the ratemaking process.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY INVOLVING J.C. Cox Utilities, Inc.?

A. The purpose of my testimony is to set forth in summary form Staff's findings and recommendations resulting from our examination concerning the above docket. These findings and recommendations are set forth in the exhibits of the Audit Department.

Q. I SHOW YOU THIS REPORT WITH ITS ATTACHED EXHIBITS, ENTITLED "REPORT OF THE AUDIT DEPARTMENT, THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA, DOCKET NO. 2003-277-S, J.C. Cox Utilities, Inc.". DID YOU AND THE AUDIT STAFF PREPARE THIS DOCUMENT?

A. Yes, the report was prepared by me and other members of the Audit Department Staff.

Q. (MARK FOR IDENTIFICATION). WOULD YOU PLEASE SUMMARIZE THE CONTENTS OF THIS REPORT?

A. As outlined in the report's index, pages 1 through 3 contain the Staff's analysis of the report, with the remaining pages 4 through 27 containing the Audit Staff's supporting exhibits. The major part of my testimony will refer to Audit Exhibits A,B and C entitled Operating Experience and Operating Margin. Such

Exhibits, as do all of the Audit Staff's exhibits, utilize a test year ending December 31, 2002.

Q. **DO YOU HAVE ANY FURTHER EXPLANATION OF AUDIT EXHIBITS A,B and C?**

A. Yes, the Audit Staff has prepared these exhibits in compliance with the Commission's standard procedures as to calculating income and operating margin for wastewater companies. A brief description of Audit Exhibits A,B and C is as follows:

Column (1): Represents the Company's per book operations for the test year ended December 31, 2002 as filed by the Company in its application for the requested rate increase. These numbers were verified by the Staff as part of our review of the Company's books and records.

Column (2): The Staff's Accounting and Pro Forma Adjustments are detailed in this column. These adjustments were made by the Audit Staff in order to correct or normalize the Company's per book operations and are detailed separately in Audit Exhibits A-1,B-1 and C-1, respectively.

Column (3): The Staff's computation of the Company's normalized test year prior to the effect of the proposed increase is detailed in this column of Audit Exhibits A,B and C.

Column (4): The Staff's adjustments for the proposed increase as furnished by the Utilities Department and all related tax and expense adjustments that are associated with the proposed increase are detailed in this column.

Column (5): The Staff's computation of the Company's normalized test year after the effect of accounting and pro forma adjustments and the effect of the proposed increase and the associated tax and expense adjustments are detailed in this column.

Q. YOUR REPORT HAS INCLUDED THREE OPERATING EXPERIENCE AND OPERATING MARGIN EXHIBITS. IS THIS DIFFERENT THAN THE NORMAL STAFF REPORT?

A. Yes, it certainly is different.

Q. WHY HAS THE STAFF CHOSEN TO SHOW THREE OPERATING EXPERIENCE AND OPERATING MARGIN EXHIBITS?

A. This particular rate request is not similar to most rate requests that come before this Commission. The Company has requested the Commission to grant rate relief based on a number of circumstances that may or may not actually take place. As a result the Staff was of the opinion that several exhibits would be required to address each of these possible circumstances.

Q. PLEASE ELABORATE ON THE POSSIBLE CIRCUMSTANCES.

A. According to the Application, DHEC has mandated in a consent order that the Company eliminate the current treatment facility and either (1)construct a new wastewater treatment facility or (2)connect its sanitary sewer lines to the wastewater treatment facility of the town of Williamston, S.C. Audit Exhibit A of my report is based on known and measurable changes to test year operations and shows the operating experience and operating margin under current conditions since none of the above changes have taken place and currently it is not known when or if they will occur. Under this assumption there would be no expenditures to retire the lagoon, to build a lift station or to construct a new wastewater treatment plant. Also, there would be no expense allowed for monthly fees to the town of Williamston or annual fees to the County of Anderson.

Audit Exhibit B shows the Company's proposal to interconnect with the Town of Williamston, S.C. This exhibit includes projected expenses made by the Company for a proposed interconnection with the City of

Williamston, S.C. It should be noted that none of these expenses have been incurred and Staff is including Audit Exhibit B as information only for the Commission's consideration. This scenario is similar to that which occurred with Moore Sewer in its last rate case before the Commission in Docket #2003-41-S. As a result, the waste would be transported by the Company through the use of a new lift station to the City of Williamston, S.C. where the waste would then be treated.

Under this proposal, the Company would retire its existing lagoon. Staff has recommended a 5 year extraordinary write-off of the net book value of the lagoon. This write-off would have an effect on the Company's depreciation expense. This interconnection would also affect operating and maintenance and general and administrative expenses and would result in a monthly treatment fee by the Town of Williamston and an annual transportation fee by Anderson County for use of their excess capacity as recommended by the Commission's Utilities Department.

Audit Exhibit C is presented to show the Company's proposal if the proposed connection with the Town of Williamston failed to occur. Audit Exhibit C, similar to

Audit Exhibit B, includes projected expenses made by the Company for construction of a new wastewater treatment plant in the event an interconnection cannot be made and is based on estimates only. None of these expenses have been incurred and Staff is including this Audit Exhibit C as information only for the Commission's consideration.

This addition to the Company's plant in service would be the result of a DHEC consent order and would increase the Company's depreciation and interest expense. In addition, as would be the case if the Company interconnects to the Town of Williamston, S.C., the Company would also have to decommission the lagoon. Under this scenario, Staff has recommended a 5-year write-off of the net book value of the lagoon.

Q. **DOES THAT CONCLUDE YOUR COMMENTS CONCERNING THE NEED FOR THREE DIFFERENT OPERATING EXPERIENCE AND OPERATING MARGIN EXHIBITS?**

A. Yes, it does.

Q. **WHY HAS THE STAFF PROVIDED TESTIMONY REGARDING THESE PROPOSALS?**

A. Staff's position in this matter relates to the uncertainty as it relates to the future of this system.

At present there is no evidence that the Town of Williamston is willing to allow the Company to connect to its sewer system. No credible evidence has been brought forth to indicate that any action is going to take place regarding either the interconnection with the Town of Williamston or the construction of a wastewater treatment plant and the cost associated with either proposal.

Q. WOULD YOU PLEASE ELABORATE ON THE CALCULATIONS IN AUDIT EXHIBIT A?

A. As shown in Column (1), per book operations were used by Staff to compute a "Net Loss For Return" of $(19,139). This was based on Operating Revenue of $6,541 less Operating Expenses of $25,680. After adjusting the Net Loss For Return for Interest Expense, the Staff computed a negative operating margin of (302.64)%.

In Column (2), the Staff's Accounting and Pro Forma adjustments are presented. These adjustments are shown in more detail in Audit Exhibit A-1.

Column (3) presents per book operations as adjusted by the Staff. After such adjustments, the Staff computed a "Net Loss For Return" of $(20,630). This was the result of Operating Revenues of $6,131 less Operating

Expenses of $26,761. By using the "Net Loss For Return" as adjusted and the adjusted interest expense of $2,728, the Staff computed a negative operating margin of (380.98)%.

Column (4) presents the Staff's adjustments resulting from the proposed increase with the Service Revenue portion of this adjustment being supplied by the Utilities Department. These adjustments are also detailed in Audit Exhibit A-1.

Column (5) presents per book operations as adjusted to normalize the test year and after the proposed increase is added to revenue. As a result "Net Income For Return" of $5,426 was computed by the Staff. Such income was based on Operating Revenue of $33,047 less Operating Expenses of $27,621. By using the resulting "Net Income For Return" of $5,426 and the adjusted interest expense of $2,728, the Staff computed an operating margin of 8.16%.

Q. WOULD YOU PLEASE ELABORATE ON THE CALCULATIONS IN AUDIT EXHIBIT B?

A. As shown in column (1), per book operations were used by Staff to compute a "Net Loss For Return" of $(19,139). This was based on Operating Revenue of $6,541 less Operating Expenses of $25,680. After adjusting the Net Loss For Return for Interest Expense the Staff computed a negative operating margin of (302.64)%.

In Column (2), the Staff's Accounting and Pro Forma adjustments are presented. These adjustments are shown in more detail in Audit Exhibit B-1.

Column (3) presents per book operations, as adjusted by the Staff. After such adjustments, the Staff computed a "Net Loss For Return" of $(27,780). This was the result of Operating Revenues of $6,131 less Operating Expenses of $33,911. By using the "Net Loss For Return" as adjusted and the adjusted interest expense of $4,453, the Staff computed a negative operating margin of (525.73)%.

Column (4) presents the Staff's adjustments resulting from the proposed increase with the Service Revenue portion of this adjustment being supplied by the Utilities Department. These adjustments are also detailed in Audit Exhibit B-1.

Column (5) presents per book operations as adjusted to normalize the test year and after the proposed increase is added to revenue. As a result, "Net Loss For Return" of $(1,081) was computed by the Staff. Such loss was based on Operating Revenue of $33,047 less Operating Expenses of $34,128. By using the resulting "Net Loss For Return" of $(1,081) and the adjusted interest expense of $4,453 the Staff computed a negative operating margin of (16.75)%.

Q. WOULD YOU PLEASE ELABORATE ON THE CALCULATIONS IN AUDIT EXHIBIT C?

A. As shown in column (1), per book operations were used by Staff to compute a "Net Loss For Return" of $(19,139). This was based on Operating Revenue of $6,541 less Operating Expenses of $25,680. After adjusting the Net Loss For Return for Interest Expense the Staff computed a negative operating margin of (302.64)%.

In Column (2), the Staff's Accounting and Pro Forma adjustments are presented. These adjustments are shown in more detail in Audit Exhibit C-1.

Column (3) presents per book operations as adjusted by the Staff. After such adjustments, the Staff computed a "Net Loss For Return" of $(44,469). This was the result of Operating Revenues of $6,131 less Operating Expenses of $50,600. By using the "Net Loss For Return", as adjusted, and the adjusted interest expense of

$14,300, the Staff computed a negative operating margin of (958.56)%.

Column (4) presents the Staff's adjustments resulting from the proposed increase with the Service Revenue portion of this adjustment being supplied by the Utilities Department. These adjustments are also detailed in Audit Exhibit C-1.

Column (5) presents per book operations as adjusted to normalize the test year and after the proposed increase is added to revenue. As a result, "Net Income For Return" of $32,880 was computed by the Staff. Such Income was based on Operating Revenue of $88,574 less Operating Expenses of $55,694. By using the resulting "Net Income For Return" of $32,880 and the adjusted interest expense of $14,300, the Staff computed an operating margin of 20.98%.

Q. WOULD YOU PLEASE BRIEFLY DESCRIBE THE OTHER AUDIT EXHIBITS IN STAFF'S REPORT?

A. Audit Exhibits A-1, B-1 and C-1 present the details of the adjustments to correct or normalize the test year, with Audit Exhibits A-2, B-2 and C-2 presenting the Company's customer growth computation. Audit Exhibit A-3 presents the Company's Income Statement and Audit Exhibit A-4 is a presentation of the Balance Sheet.

Q. **WHICH ADJUSTMENTS ON AUDIT EXHIBITS A-1, B-1 and C-1 IN YOUR REPORT ARE THE RESPONSIBILITY OF THE AUDIT DEPARTMENT?**

A. The adjustments marked with an (A) are the responsibility of the Audit Department witness and the adjustments marked with a (U) are the responsibility of the Utilities Department witness. The adjustments that contain both an (A) and a (U) denote responsibility of both departments.

Q. **WOULD YOU PLEASE EXPLAIN STAFF'S PROPOSED ADJUSTMENTS AS SHOWN IN AUDIT EXHIBIT A-1?**

A. The Staff proposed nine accounting and Proforma adjustments and one adjustment for the proposed increase. **Adjustment No.1** was made by the Utilities Department to annualize revenues based on year-end customers with the Audit Staff computing a $(3) effect on gross receipts taxes. **Adjustment No.2** was made by the Company to record the monthly treatment fee and the annual transportation fee assuming the utility is allowed to connect to the Town of Williamston's sewer system. Staff did not make this adjustment since the interconnection has not yet been made and it is not known when or if an interconnection will take place. **Adjustment No.3** was made by Staff to reclassify interest charges to below-the-line for rate-making purposes. Staff has included annualized interest expense in the booking of income tax expense and in the computation of the operating margin based on interest synchronization. Interest expense has traditionally been considered to be a below-the-line expense for rate-making purposes by this Commission. Since the Company has a capital structure consisting of negative equity and 100% debt, Staff has proposed to use a 50%/50% debt/equity capital structure. Such a proposed capital structure is considered by the Staff to be more representative of an ideal capital structure for a wastewater utility whose capital structure is "skewed" by debt or equity. The Company's Net Plant In Service at the end of the test year has been allocated by Staff based on the 50%/50% capital structure ratio and using the Company's embedded cost of debt. This formula produces annualized interest which is deductible for the purpose of calculating income taxes and has been included by Staff in the computation of the operating margin. Therefore, the operating margin which a utility has the opportunity to earn covers interest expense associated with the debt portion of Plant In Service. **Adjustment No.4** was made by the Company for estimated interest expense to be incurred on funds borrowed to construct the required lift station. Staff has included annualized interest as previously discussed based on interest synchronization. **Adjustment No.5** was made by the Company to adjust office supply expenses for estimated increases. Staff did not adjust office expenses since the Company could not provide support for this adjustment. **Adjustment No. 6** was made by the Company to include its total long-term debt at 12-31-02 in operating expenses. This debt included loans from Ellison and Ellison Partnership, the owners of the utility, and was used to meet operating expense requirements. Staff has included annualized interest expense based on interest synchronization, as previously discussed in the computation of income taxes, and in the computation of the operating margin, therefore, Staff did not propose this adjustment. **Adjustment No. 7** was made by the Staff to amortize actual rate case expenses of $19,000 over 5 years.

Staff's adjustment is based on the low end of fees to be charged by the law firm of Elliott & Elliott per letter dated 12-01-03. The 5 year amortization period is based on the total number of years the present owners have operated the system without filing for rate relief. The Company proposes to include total estimated rate case expenses in the test year. **Adjustment No. 8** is proposed by Staff to annualize depreciation expense on existing year-end Plant In Service using a rate of 2.5%, as recommended by the Commission's Utilities Department. The Company used an accelerated depreciation method to compute the "Per Books" depreciation expense. **Adjustment No. 9** is proposed by the Company to annualize depreciation expense for the cost of constructing a required lift station and new lines to transport sewage to the Town of Williamston. The Company also included projected or estimated increases in operating and maintenance and general and administrative expenses and taxes other than income.Staff did not make this adjustment since an interconnection has not been made and it is not known when or if an interconnection will take place. **Adjustment No. 10** is proposed by the Staff and Company for the effects of the proposed increase as computed by the Commission's Utilities Department. Staff's adjustment also proposes to adjust gross receipts tax and income taxes for the effects of the proposed increase.

Q. WOULD YOU PLEASE EXPLAIN STAFF'S PROPOSED ADJUSTMENTS AS SHOWN IN AUDIT EXHIBIT B-1?

A. The Staff proposed eleven accounting and Proforma adjustments and one adjustment for the proposed increase. I will discuss the adjustments that differ from Exhibit A-1. **Adjustment No.2** was made by Staff to eliminate outside operator's fees and chemicals. Upon connection to the Town of Williamston's sewer system, these expenses will no longer be required. With **Adjustment No. 3** The Staff and Company propose to record the monthly treatment fee and the annual transportation fee assuming the utility is allowed to connect to the Town of Williamston's sewer system. Staff's adjustment includes a $700 monthly fee to be paid to the Town of Williamston to treat the sewage and a $4,128 annual fee to Anderson County for use of its excess capacity to transport the sewage. Included in the Company's adjustment is an estimated expense of

$8,280 along with a charge of $310 for chemicals and supplies. **Adjustment No. 8** was made by Staff to amortize plant closure expenses, consisting of $10,000 for decommissioning of the lagoon and $948 in engineering fees, over a 5 year period, as recommended by the Utilities Department. The Company has not yet incurred these expenses but is under DHEC consent order to do so. Closure expenses are based on an engineering study performed by the Goldie & Associates Engineering Firm. The Company included its total long-term debt at 12-31-02 of $99,507 in its computation of G&A expenses.

Adjustment No. 9 was made by the Staff and Company to annualize depreciation expense for the cost of constructing a required lift station and new lines to transport sewage to the Town of Williamston. The Staff included $98,802 in costs from the proposal submitted by Goldie & Associates, an engineering service company, to calculate the adjustment using 15 years for the lift station and 40 years for the lines to transport the sewage, as recommended by the Commission's Utilities Department. The Company used estimated costs of $110,000, a recovery period of 15 years and an accelerated cost recovery method to compute depreciation expense. The Staff and Company also included projected increases in operating and maintenance and general and administrative expenses and taxes other than income.

Adjustment No. 10 is the extraordinary retirement adjustment made by Staff for the net book value of the existing lagoon to be decommissioned upon connection to the Town of Williamston. Staff proposes to amortize the extraordinary retirement over 5 years, as recommended by the Commission's Utilities Department.

Adjustment No. 11 is Staff's annualized depreciation adjustment based on Plant In Service at December 31, 2002, excluding lagoon costs to be retired upon connection to the City of Williamston's treatment plant. Staff's depreciation adjustment was based on rates recommended by the Commission's Utilities Department.

Q. WOULD YOU PLEASE EXPLAIN STAFF'S PROPOSED ADJUSTMENTS AS SHOWN IN AUDIT EXHIBIT C-1?

A. The Staff proposed eight accounting and Proforma adjustments and one adjustment for the proposed increase. I will discuss the adjustments that differ with Exhibits A-1 and B-1. **Adjustment No. 6** annualizes depreciation expense for the cost of constructing a DHEC required wastewater treatment plant. The Staff and the Company included estimated costs submitted by DHEC since no proposal by an outside party has been submitted. Depreciation expense was computed using a 40 year life as recommended by the Commission's Utilities Department. The Staff and Company also included increases in operating and maintenance, general and administrative expenses and liability insurance as projected by the Company.

Adjustment No. 8 is Staff's annualized depreciation adjustment based on Plant In Service at December 31, 2002, excluding lagoon costs to be retired upon construction of the wastewater treatment plant. Staff's depreciation adjustment was based on rates recommended by the Commission's Utilities Department.

Adjustment No. 9 is proposed by the Staff and the Company for the effects of the proposed increase as recommended by the Commission's Utilities Department. Staff's adjustment also proposes to adjust gross receipts tax and income taxes for the effects of the proposed increase.

Q. WOULD YOU PLEASE EXPLAIN THE STAFF'S CUSTOMER GROWTH EXHIBITS A-2, B-2 and C-2?

A. Yes. The Company's customer counts did not change during the test year resulting in no customer growth for either Audit Exhibits A-2, B-2 or C-2.

Q. DO YOU HAVE ANY RECOMMENDATIONS CONCERNING THE COMPANY'S RECORD KEEPING PRACTICES?

A. Staff noted that the Company was not keeping its books in accordance with the NARUC chart of accounts. It is Staff's recommendation that the Company begin recording its revenues, expenses and other transactions using the NARUC chart of accounts for water and wastewater companies.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.